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Parent =

CFC-A =

Country A =

Insurance Law =

Act =

Authority =

Annual Return =

X =

Y =

Z =

Dear :

We respond to your letter dated X, requesting a ruling that certain reserves for annuity contracts required to be set forth on the Annual Return filed with the insurance regulators of Country A are an appropriate means of measuring income within the meaning of Code section 954(i)(4)(B)(ii) and, accordingly, such reserves may be used in determining foreign personal holding company income under Code section 954. (Hereinafter, all section references are to the Internal Revenue Code of 1986, as amended.)

The rulings given in this letter are based on facts and representatives submitted by the Parent and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the materials submitted in support of the request for rulings. Verification of the information, representations and other data may be required as part of the audit process.

Facts

Parent is a publicly-traded corporation that is engaged in the worldwide insurance and financial services business through its various subsidiaries. Parent is in the process of establishing an insurance company, CFC-A, under the laws of the Country A. CFC-A will be wholly owned by Parent or by a wholly-owned Parent subsidiary. CFC-A will engage in the insurance business in Country A.

CFC-A's operations will focus on annuity products designed for the Country A pension plan market. CFC-A will issue single premium payout annuity contracts to Country A pension plans. The contract is designed to provide a stream of guaranteed annuity payments to cover an employer's existing pension obligations for its Country A resident employees. The contract will be issued to cover obligations to current retirees and active employees. The source of the consideration for the annuities will be a combination of employer and employee contributions.

The contract is a single premium product and there are no future premiums required by or allowed under the contract. There is no guaranteed nonforfeiture benefit under the contract, no guaranteed cash surrender value and, accordingly, no surrender charge. The contract has no accumulation value or policyholder fund, and there is no guaranteed or illustrative crediting interest rate.

Typically, a pension plan will terminate shortly after the annuity contract is purchased at which time the employee becomes the policyholder. Benefits are payable to employees only upon retirement or upon the employee's death before retirement as a spousal benefit. The employee can elect to have benefits commence earlier or later than the date of normal retirement (within a restricted range as provided by the contract). Should the employee make such an election, the amount of future benefit payments will be actuarially adjusted using actuarial assumptions guaranteed at issue so that the present

value of the adjusted benefit starting on the adjusted retirement date will be equivalent to the present value of the original benefit starting on the normal retirement date.

Three payout options will be available: (i) benefits paid during the life of the employee only, (ii) paid for the longer of a term certain or the employee's life, or (iii) paid until both employee and spouse are no longer living. The contract will also have three benefit options: (i) a level benefit over the payout period, (ii) benefits that increase annually by a fixed percentage, or (iii) benefits that increase annually by the change in the rate of inflation.

At retirement, the employee may choose to take a lump sum cash withdrawal of up to Y percent of the present value of his future retirement benefit. If a lump sum withdrawal is elected, the future benefit payments will be adjusted accordingly.

In the unlikely event that a pension plan does not terminate after the annuity contract is purchased, the plan remains as the policyholder. In addition to the options described above, a covered employee who leaves employment prior to retirement will generally have the option of either receiving an individual CFC-A contract covering the promised benefits or receiving the benefits in a lump sum from the plan. If the latter option is selected, CFC-A will commute the future retirement benefits of that employee and provide to the plan a lump sum amount that is actuarially equivalent to the present value of those future retirement benefits.

It is planned that CFC-A will also reinsure annuity contracts written by unrelated Country A insurers. The reinsured contracts are expected to be primarily pension plan contracts.

CFC-A expects to derive more than 50 percent of its aggregate net written premiums from issuance of annuities covering risks in connection with the lives or health of residents of Country A and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person as defined in Code section 954(d)(3).

CFC-A will issue and reinsure annuity contracts in connection with the lives and health of residents of Country A and derive more than 30 percent of its net written premiums from contracts that cover Country A risks with respect to which no policyholder, insured, annuitant or beneficiary is a related person within the meaning of Code section 954(d)(3).

Parent has represented that CFC-A would be subject to tax under Subchapter L if it were a domestic corporation.

In Country A, financial services firms, including insurance companies, are regulated by the Authority. The Authority is an independent, non-governmental body, given statutory powers under the Act. The Country A Treasury appoints the Authority Board. The Authority is accountable to the Treasury. The Authority requires that each insurance company authorized by the Authority to conduct insurance business in the Country A file

an annual insurance return ("Annual Return"). The Annual Return consists of audited financial information and reports of auditors that the Authority uses for supervision. Annual Return requirements include preparation of a revenue account, a balance sheet and profit and loss account for the year; an actuarial investigation every 12 months; an audit of accounts; and depositing specific reports with the Authority. The deposited documents are open to public inspection.

CFC-A will be licensed by the Authority to sell annuities to residents of Country A and to reinsure similar contracts. Licensing by the Authority is required in order to conduct insurance business in Country A. CFC-A will be subject to regulation by the Authority as an insurance company. The annuity contracts to be issued by CFC-A will be regulated as such by the Authority.

Under Authority rules, CFC-A will be required to maintain financial resources, adequate as to amount and quality, to ensure that there is no significant risk that its liabilities to policyholders cannot be met as they fall due. Applicable rules specify the methods and assumptions to be used by an insurance firm in calculating its required reserves.

In general, a firm must establish reserves using a prospective actuarial valuation on prudent assumptions of all future cash flows expected to arise under, or in respect of, each of its long-term insurance contracts. A prospective valuation sets reserves at present value of the future net cash flows. The actuarial valuation of reserves must be based on methods and assumptions that are appropriate to the business of the firm, consistent year-to-year without arbitrary changes, consistent with the method for valuing assets and that include appropriate margins for adverse deviation of relevant factors. Relevant factors include future investment returns, expenses, mortality, morbidity, policyholder options, persistency and reinsurance.

Under Authority rules, insurance company investments generally must be marked to market, meaning valued at readily available close out prices from independent sources. Where marking to market is not possible, assets must be marked to model using a model based on market input and the modeled prices must be checked regularly against market or other relevant sources. Consistent with the requirement that related assets must be marked to market, Country A rules require that reserves must be marked to market as well.

The Authority has established special reserve requirements for index-linked liabilities, which include CFC-A's inflation-adjusted benefit described above. Index-linked liabilities are those in respect of index-linked benefits. Index-linked benefits are those provided under a long-term contract of insurance determined by reference to an index of the value of property of any description.

Under Country A rules, the method for calculating reserves is comparable to the Commissioner's Annuities Reserve Valuation Method ("CARVM") prescribed in Code section 807(d)(3). In these circumstances, where there is a single premium payment

and no guarantee except with respect to the annuity payments, the present value of the guaranteed benefit using valuation and mortality assumptions produces a result that is consistent with CARVM.

In addition to computing reserves as described above for Country A regulatory purposes, an insurer will use the same reserve amount in calculating Country A income tax in connection with its pension plan business.

The reserves CFC-A is required to establish under Country A rules are not catastrophe, deficiency, equalization or similar reserves.

Parent has represented that for purposes of determining foreign personal holding company income, CFC-A would follow the Country A mark-to-market method applicable to assets under Country A financial statement rules and would base reserves only on amounts attributable to policyholder benefits, if a favorable ruling is granted allowing CFC-A to use foreign statement reserves under Code section 954(i).

Parent has requested a ruling that the reserves as required to be set forth by CFC-A for its annuity contracts on its Country A Annual Return provide an appropriate means of measuring income within the meaning of Code section 954(i)(4)(B)(ii) and, accordingly, the amount of these reserves may be used in determining foreign personal holding company income under Code section 954, provided that assets are marked to market consistent with Country A rules and the reserve is based only on amounts attributable to policyholder benefits.

Law

In general, a United States shareholder of a controlled foreign corporation ("CFC") must include in gross income its pro-rata share of the CFC's Subpart F income for each year. Sec. 951(a). Subpart F income includes, among other types of income, foreign base company income. Sec. 952(a). Section 954(a)(1) defines the term "foreign base company income" to include, among other types of income, foreign personal holding company income. Section 954(c)(1) sets forth the types of income (e.g., interest and dividends) that are considered to be foreign personal holding company income. Sec. 954(c)(1)(A). Section 954(i)(1) provides that, for purposes of section 954(c)(1), foreign personal holding company income does not include "qualified insurance income" of a "qualifying insurance company."

Section 953(e)(3) defines a qualifying insurance company as any CFC which:

(A) is subject to regulation as an insurance company by its home country, and is licensed, authorized, or regulated by the applicable insurance regulatory body for its

home country to sell insurance or annuity contracts to persons other than related persons (within the meaning of Code section 954(d)(3)) in such home country;

(B) derives more than 50 percent of its aggregate net written premiums from the issuance by such CFC of contracts covering applicable home country risks of such corporation and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (as defined in Code section 954(d)(3)); and

(C) is engaged in the insurance business and would be subject to tax under Subchapter L if it were a domestic corporation.

Code section 953(e)(2)(B)(ii) defines the term “applicable home country risks” to include risks in connection with the lives or health of residents of the home country of the qualifying insurance company issuing the contract covering the risks.

Section 954(i)(2) defines the term “qualified insurance income” to mean income of a qualifying insurance company falling into either of two categories. First, income received from unrelated persons and derived from investments made by a qualifying insurance company or qualifying insurance company branch (collectively referred to as a “QIC”) either of its reserves allocable to exempt contracts or of 80 percent of its unearned premiums from exempt contracts (as both are determined in accordance with section 954(i)(4)) is qualified insurance income. Sec. 954(i)(2)(A). Second, income received from unrelated persons and derived from investments made by a QIC of an amount of its assets allocable to exempt contracts equal to: (1) in the case of property, casualty, or health insurance contracts, one-third of the premiums earned on those contracts during such year; and (2) in the case of life insurance or annuity contracts, 10 percent of the reserves described in section 954(i)(2)(A) for such contracts. Sec. 954(i)(2)(B).

Exempt contracts are defined under section 953(e)(2) to include insurance or annuity contracts issued by a QIC in connection with the lives or health of residents of a country other than the U.S. but only if the company derives more than 30 percent of its net written premiums from otherwise exempt contracts which cover applicable home country risks and with respect to which no policyholder, insured, annuitant or beneficiary is a related person within the meaning of section 954(d)(3).

Section 954(i)(4)(B)(i) generally provides that in the case of life insurance and annuity contracts, a QIC’s reserves allocable to exempt contracts are equal to the greater of (1) the net surrender value of the contract or (2) the reserve determined under Code section 954(i)(5). Code section 954(i)(4)(B)(ii), however, provides:

The amount of the reserve under [Code section 954(i)(4)(B)(i)] shall be the foreign statement reserve for the contract (less any catastrophe, deficiency, equalization, or similar reserves), if, pursuant to a ruling request submitted by the taxpayer or as provided in published guidance, the Secretary determines that the

factors taken into account in determining the foreign statement reserve provide an appropriate means of measuring income.

Code section 954(i)(4)(B)(ii) was enacted by section 614 of the Job Creation and Worker Assistance Act of 2002. The Staff of the Joint Committee on Taxation explains this provision as follows:

. . . The provision does, however, permit a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve for such contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes. In seeking a ruling, the taxpayer is required to provide the IRS with necessary and appropriate information as to the method, interest rate, mortality and morbidity assumptions and other assumptions under the foreign reserve rules so that a comparison can be made to the reserve amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under Subchapter L of the Code (with the modifications provided under present law for purposes of these exceptions). The IRS also may issue published guidance indicating its approval. . . .

Staff of the Joint Comm. on Taxation, Technical Explanation of the “Job Creation and Worker Assistance Act of 2002” at 72, JCX-12-02 (March 6, 2002).

Analysis

CFC-A will be subject to regulation as an insurance company by Country A. It will be licensed, authorized and regulated by the Authority, which is the insurance regulatory body for Country A, to sell annuity contracts to persons other than related persons (within the meaning of Code section 954(d)(3)) in Country A. Parent has represented that CFC-A expects to derive more than 50 percent of its aggregate net written premiums from its issuance of annuity contracts covering risks in connection with the lives or health of residents of the Country A and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (as defined in Code section 954(d)(3)). Finally, CFC-A will be engaged in the insurance business and would be subject to tax under Subchapter L if it were a domestic corporation. Accordingly, CFC-A qualifies as a QIC.

CFC-A will issue annuity contracts in connection with the lives and health of residents of Country A, a country other than the U.S. Moreover, CFC-A expects to derive more than 30 percent of its net written premiums from contracts that cover Country A risks with

respect to which no policyholder, insured, annuitant or beneficiary is a related person within the meaning of Code section 954(d)(3). CFC-A's annuity contracts are, therefore, exempt contracts within the meaning of Code section 953(e)(2).

We have determined that the reserves held by CFC-A are foreign statement reserves within the meaning of Code section 954(i)(4)(B)(ii) for the following reasons:

1. CFC-A must establish, maintain and calculate the reserves in accordance with rules prescribed by the Authority.
2. CFC-A must set forth the reserves on the Country A Annual Return, which must be filed annually with the Authority. As such, the reserves are the measure of the legal obligations to policyholders on the financial statement used for regulatory purposes by life insurance companies doing business in the Country A generally (whether U.S.-owned, locally owned, or owned by companies headquartered in other foreign countries).
3. The Authority requires that CFC-A hold reserves for the fulfillment of claims of policyholders and their beneficiaries.
4. The reserves are not catastrophe, deficiency, equalization, or similar reserves.

Rulings

Based on the information submitted and the representations made, we rule as follows:

Under the facts set forth above, the reserves required to be set forth by CFC-A on its Country A Annual Return provide an appropriate means of measuring income within the meaning of Code section 954(i)(4)(B)(ii) and, accordingly, the amount of these reserves may be used in determining CFC-A's foreign personal holding company income under Code Section 954, provided that assets are marked to market consistent with Country A rules and the reserves include only amounts attributable to policyholder benefits.

Caveats

We express no opinion on any provisions of the Code or regulations not specifically covered by the above ruling.

Procedural Statements

This ruling is directed only to Parent. Code section 6110(k)(3) provides that it may not be used or cited as precedent. Parent should attach a copy of this ruling letter to its Federal income tax return for the taxable years to which this letter applies.

In accordance with the power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

Steven D. Jensen
Senior Counsel, Branch 5
Office of Associate Chief Counsel
(International)